What Would A Board Do For Us?
- the first hour's advice.

The majority owner of a private company asks the question, and ignores the advice.

BACKGROUND

Time Frame: 2013-2014
Company: Onyx Online, LLC
Financials: $265MM annual revenue, 15% EBTIDA
Business: Web-based merchandising company
Ownership: Five partners,

Bill – 32%, co-founder and director, however no longer an employee
Steve – 32%, CEO and director
Nick – 32%, co-founder and director, however no longer an employee
Ron – 4%, director, early employee and continuing mid-level manager

Disclosure: The above details have been altered somewhat for the purpose of confidentiality. The specifics of what transpired and the magnitude of the resulting repercussions have not been exaggerated in any way.

CASE DESCRIPTION

Bill initially contacted Caganco Incorporated by telephone. An investment banker he met referred him to me. Although Bill owned controlling interest in Onyx, which he originally founded, he was no longer involved in the management of the company. Steve had joined Onyx as the CEO two years after its founding. He purchased equity and built it into a very successful and profitable enterprise.

Steve had mentioned to Bill that he felt that they should consider the possibility of an IPO in the next year or two. The company did not require capital however it would provide both working capital, and liquidity and diversification for the owners. At that time Bill retained Caganco for a short consulting engagement to educate him on the governance implications of being a public company in general, and a board of directors in particular.

Onyx had a legal board (board of managers as an LLC); it was comprised of all four owners and only met formally once a year. The non-executive directors got quarterly high-level summary financials, and they talked informally with the CEO on a monthly basis.

PART 1

We started off with a one-hour consulting session in his office. Bill is very intelligent, and inquisitive. His background is somewhat technical, but he started the company with no real business background. He asked a lot of questions on a wide variety of business topics in addition to those on corporate governance infrastructure. Numerous questions were about how boards: how they were formed and managed, how they derived their authority, who was their fiduciary duty to, how they made decisions, how management interacted with them, and more.

Intermittently I asked him questions about the company so I could better tailor specific information to his particular situation. After about an hour, he had to draw our first meeting to a close. He asked in conclusion, “So, what exactly would a board do for us?”

PART 2

From there the conversation went as follows.
Cagan: “A board would provide oversight and accountability in the form of an independent perspective on all aspects of your business.”
Bill: “Why do we need that?”
Cagan: “Because your current board members and management have limited experience, and there are many things that could be gained from independent directors with specific expertise in key areas where your current team is not as strong as they could be.”
Bill: “Can you give me one example?”
Cagan: “Certainly. A good board would make you aware of significant risks that could be detrimental to the business.”
Bill: “Like what?”
Cagan: “Well, for example, based on the limited information you have given me in the last hour, there is one critical risk that could potentially drastically harm Onyx, even put it out of business very quickly.”
Bill: “What are you talking about?”
Cagan: “The Federal Trade Commission (FTC).”
Bill: “We have nothing to worry about, we have a compliance department as required and we follow all the rules.”
Cagan: “That is not enough. FTC is like the IRS and the SEC. They can investigate anyone they deem appropriate. In the last hour you told me the following:

1. You have a large inbound call center.
2. You invoice 2,500,000 of your subscriber’s credit cards between $30 each month.
3. Onyx is profitable, and since your recurring monthly revenue is so strong you distribute most of the profits to the owners monthly.
4. You have no debt, no lines of credit, and a minimum of working capital.
5. You are proud that Onyx has less than 1% credit charge-back rate (which is very good for this industry).”

Cagan continued, “An experienced board would tell you this is a huge risk, because if that 1% of your customers filed a complaint with the FTC each month there would be between 100,000 to 250,000 complaints on the FTC’s desk within 3-6 months. Even if you had already refunded their money and made them happy it would still have raised a red flag with the FTC, and they would likely investigate. Furthermore, if they are concerned enough they can get an injunction to prohibit you from billing any credit cards while they investigate. With no working capital, Onyx is out of business.”
Bill: “That seems pretty unlikely, however how would a board mitigate that?”
Cagan: “Good question. First, they would point it out and encourage management to develop a plan. This might include retaining more working capital, retaining legal counsel with FTC experience who could guide the further improvement of practices and other defensive strategies, and this is so important that I would recommend electing a board director with specific FTC Knowledge.”

PART 3

That first meeting ended. Several more took place. He extended the engagement and asked that I present him with some actual possible board candidates that he could interview before making a final decision on adding independent directors. I identified several highly qualified candidates with varied backgrounds. He did interview some. One candidate had been an attorney with the FTC for 17 years, and an attorney with the Bureau of Consumer Affairs for 5 years, and was then serving as the senior counsel for intellectual property and consumer privacy for a Fortune 100 consumer product company.

A short time later Onyx received an attractive acquisition offer from a Multi-billion dollar company and therefore put the formation of a board on hold.

PART 4

Unfortunately the acquisition due diligence period was extended several times. Finally the acquirers terminated the deal. After much follow up it was discovered that they called it off due to concerns about the FTC and regulatory issues. But the story does not end there. A few months later Onyx did receive a letter from the FTC. It noted their intention to investigate suspected regulatory violations and proposed a settlement, which was unacceptable to Onyx management. Onyx proceeded to engage any number of attorneys, and spent countless hours of management time and company money to deal with the investigation. Ultimately it was settled, approximately 17 months after our initial one-hour meeting. The settlement cost to Onyx was $22.5M, plus their legal and other costs.

CONCLUSION

The consequence for this advice not taken was a high price indeed. It could likely have been significantly reduced if not avoided entirely, had the company upgraded their governance and formed a board when first recommended. A best-of-class corporate infrastructure is only a foundation. The documentation and process alone will not necessarily reap the maximum benefits. The true differentiator is the people – the owners/shareholders, the management, and the board members – who will ultimately make the enterprise excel. The careful and deliberate recruitment of a diversified mix of directors with skills, experience and temperament to augment management is the winning equation.

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Dennis Cagan is seasoned board director, high-technology executive and entrepreneur. Mr. Cagan has served on 68 corporate boards, both private and public, predominately early and mid-stage technology companies. Mr. Cagan is a respected CEO and Chairman of both public and private companies, a venture investor, consultant and professional board member. He has founded or co-founded over a dozen different companies, including his first software firm in 1968. In 1976 he founded his fifth company. In 1980 it was ranked #32 on the first *Inc. 100*. His first public board seat was when he took the company public in 1981. In 1979 he was the Keynote Speaker at the first COMDEX Show in Las Vegas. In 2011 he was inducted into the IT Hall of Fame - Channel Wing, administered by CompTIA. In 2013 he was honored by NACD and the Dallas Business Journal as one of 12 Outstanding Directors in North Texas. Mr. Cagan can be contacted at dennis@caganco.com.